Banking and Finance 1997: An Overview of Chartering and Regulatory Developments

Alvin C. Harrell, Oklahoma City University School of Law

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By Alvin C. Harrell

1. Introduction

On April 24-25, 1997 the Conference presented an Institute entitled Banking and Finance 1997 (Institute) in Dallas, Texas. A panel of nationally-recognized banking and consumer finance specialists described a wide range of recent developments and changes.

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III. Interstate Expansion

Michael K. O’Neal of Winstead & Soclet described expansion and acquisition opportunities after EGRPA. Between 1980 and 1995 the number of U.S. banks declined from 14,000 to 10,000, independent banks declined from around 12,000 to approximately 8,000 (a decline of one-third); and there has been a decline in the number of national banks at the rate of about 400-500 per year. Seventy-five percent of U.S. banking assets are now controlled by 250 multi-state bank holding companies. The current trend is to convert these to a single or minimum number of charters. These figures reflect the tremendous consolidation underway in the banking industry and the decline in community banking since passage of FIRREA in 1989 and the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994.

Mr. O’Neal noted that interstate branching (as opposed to interstate banking via holding company subsidiaries) is authorized as of June 1, 1997, subject to state opt-out or opt-in. Only Texas and Montana have opted out (subject to sunset provisions). Kansas, Missouri, Ohio, and Wisconsin had not acted as of the date of the Institute, but action was pending in some of those states. As a result the U.S. seems headed for full “one-charter” interstate branching after June, 1997 (although some states have imposed statewide deposit caps, and most states have “age limits” which essentially require interstate branches to be created by acquisition of an existing bank or branch). Only a few states permit de novo interstate branching.

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E.  Bona Fide Errors and Force Majeure (Qualified)

Banks handling checks may raise bona fide errors as an affirmative defense to liability if they can show by a preponderance of the evidence that the violation was not intentional and resulted from a bona fide error notwithstanding the maintenance of procedures reasonably adapted to avoid any such error.\(^7\) Additionally, if banks are delayed in acting beyond the time limits set forth in Subpart C of Reg. CC because of interruption of communications or computer facilities, suspension of payments by a bank, war, emergency conditions, failure of equipment, or other circumstances beyond their control, their time for acting is extended for the time necessary to complete the action, if they exercise such diligence as the circumstances require.\(^7\)

F.  Reliance on Board Rulings

If the Depository Bank failed to act in good faith conformity with any rule, regulation or interpretation thereof by the Board of Governors of the Federal Reserve System, then the Receiving and Paying Banks may raise this as a defense to liability.\(^7\)

G.  Statute of Limitations

See discussion supra at Part V.A.4.

VIII. Conclusion

The question of "NSF Check—Who Gets this Hot Potato?" is in many cases not easily answered. Pre-emption and supplementation of state law and ambiguities in the federal law implemented by Reg. CC make a determination of the applicable law and legal duties far from simple. The law in some instances is complicated in its very structure and in many cases is subject to varying interpretations. Federal law in this area does not seem to have been drafted with a coherent view toward reaching the truth with the more comprehensive body of applicable state law, though the FRB and the drafters of revised Articles 3 and 4 have done what they can to make the system work. Additionally, application of the law is intensely fact specific. The successful practitioner is the one who "gets" (in the sense of "understands") this complicated system and correspondingly can recommend to his or her client a cost effective and practical resolution of the matter at hand.

\(^7\) 12 U.S.C. § 661h(d).
\(^7\) 12 CFR § 229.38(b); UCC § 4-109.
\(^7\) 12 U.S.C. § 661h(e); 12 CFR § 229.38(b).

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Interstate banking is significantly altering the banking landscape, and creating new challenges for state bank regulators.\(^10\) Mr. O'Neal described the compacts and proposals for interstate state-chartered banks, designed to recognize the primacy of state regulation in the chartering state.

Mr. O'Neal also described new CRA and other legal requirements designed to prevent interstate banks from entering deposits in a state and then reinvesting the funds elsewhere to the detriment of the local economy. These issues remain somewhat controversial, and it remains to be seen what the ultimate impact will be on credit availability and local economies. The effectiveness of CRA and similar rules as a means to maintain credit availability in the context of a concentrated banking system remains to be demonstrated,\(^11\) and it seems likely that it will be increasingly important for states to maintain alternative local sources of credit for those who don't fit the required risk profile under the larger banks' credit scoring systems. Thus, state laws facilitating the operation of local nonbank and state chartered financial intermediaries will be increasingly important.\(^12\)

IV. Thrift Industry Issues

Carolyn Buck, Chief Counsel for the Office of Thrift Supervision (OTS) in Washington, D.C., noted the consolidation in the thrift industry and the loss of market share of banks and thrifts on both the deposit and loan side. The number of thrifts continues to decline although total assets have been stable and are beginning to increase.\(^13\)

What is the ideal charter for the future? For a multistate financial services provider, the unitary federal thrift charter and holding company must be considered a prime candidate. The advantages are clear: deposit insurance; federal preemption of many state consumer credit laws; the option of a diversified unitary holding company structure; and broad and flexible thrift lending and investment powers (improved by recent OTS liberalizations).

Ms. Buck noted that thrift leading and investment authority now approximates the composition of the average commercial bank portfolio, meaning that many if not most banks could now conduct their operations comfortably within the federal thrift charter. Ms. Buck detailed some recent OTS regulatory initiatives designed to further improve the flexibility of the federal thrift charter, and discussed.

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\(^10\) See id.
\(^11\) Some CRA criticisms seemed focused primarily on pressuring large banks to dispose of troubled or undercapitalized banks. The effects of these activities have been described as harming the CRA reviews. See, e.g., Irene Schetz, "Abuses Persuading Banks To Donate More to Charity," Am. Banker, June 6, 1997, at 2.
\(^12\) Despite the importance of nonbank financial services providers, particularly to low income and credit impaired consumers, some consumer groups seem determined to keep this market segment. See, e.g., Dean Amerson, "Consumer Group: Don't Let Handicapped Pensions Peer Into Your Benefits Transfer," Am. Banker., June 19, 1997, at 1.
VI. Other Miscellaneous Issues

A. Creative Sources of Potential Bank Liability

In Morrow v. First Interstate Bank, an attorney sued a bank alleging trespass to chattels, statutory conversion, false imprisonment, malicious prosecution and intentional infliction of emotional distress. The bank behavior that gave rise to these allegations? The bank retained possession of the attorney's cashier's check for less than 20 minutes while trying to decide whether to pay the check (the attorney then reached over the counter and grabbed the check from the bank branch manager). The bank ultimately avoided liability, but had to go to the U.S. Court of Appeals to do it.

In Shamrock Drilling Fluids, Inc. v. Miller, a bank customer (an accountant) defrauded investors in a bogus investment scheme. One of the investors called the bank to confirm certain of the accountant's representations (the bank representative did not recall any such conversation). The investor then alleged that the bank had an obligation to police the behavior of its customers to prevent the customer from defrauding the investors. The court held that, absent an agency relationship between the bank and its customer, there was no such duty arising from the bank-customer relationship.

However, in National Bank of Glenrock v. O'Neal, the court held a bank liable for allowing transfers from a custodial account to cover overdrafts in the depositor's general account. The court concluded that the bank should have known that the custodial account constituted trust funds prohibited from transfer under the Packers and Stockyards Act, and rejected the bank's "professed ignorance" of the Act as a defense.

And in Guidry v. Bank of LaPlace, et al, a bank was initially held liable for aiding and abetting a pyramid scheme perpetuated by a bank customer, on grounds the bank had a fiduciary duty to investigate its customer and prevent him from defrauding the public. Again this was ultimately reversed, but required the bank to pursue a costly appeal.

B. Joint and POD Accounts

In Sunwest Bank v. Colucci, the bank erroneously allowed a "payable on death" (POD) beneficiary to withdraw the account while the joint tenant was still alive. The bank was allowed to recover from the POD beneficiary on restitutionary grounds.

In Matter of Estate of Kokojohn, the bank opened a joint account for a brother and sister. The brother then sought to dispose of his interest in the account by will, and his executor attacked the validity of the joint account. The court held that the joint account signature card prevailed.

In Johnson v. Sunwest Bank of Grant County, a joint account was opened by a mother and daughter. The daughter did not contribute funds to the account. Later another joint tenant (who did contribute funds) was added. Later (just prior to the mother's death) this new joint tenant withdrew the entire account. The daughter alleged that the bank was negligent in adding the new joint tenant and allowing him to withdraw the funds. However, the court held that the daughter had no ownership interest in the account because she had not contributed any funds and there was no evidence of intent by her mother to make a gift of the account to the daughter.


149. 12 F.M & P. 405 (10th Cir. 1994).

150. 859 P.2d 711 (Wyo. 1993).


152. 872 P.2d 348 (N.M. 1994).

153. Id., citing RESTATEMENT OF RESTITUTION § 1 comment.

154. 531 N.W. 2d 94 (Iowa 1995).


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the regulatory challenges that accompany the new environment.


Moreover, the laws governing check transactions are more clear and settled than those for electronic banking. But those parties engaged in checking transactions must understand and comply with those laws if they are to maximize the benefits of the most developed and advanced instrument collection and payment system in history.

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Julie L. Williams. Ms. Corey also described and recommended a new OCC book, *The Director's Book*, describing the banking law environment for bank directors. She reaffirmed Carolyn Buck's comments about the declining market share of banks and thrifts, noting that mutual fund assets now exceed insured bank and thrift deposits, and also reaffirmed Ms. Buck's comments regarding the need for banking regulation to change with the times.

Ms. Corey indicated that the OCC's new streamlined application procedures are even more improved than at first they seem; the suggestion that applicants will be surprised at the ease with which applications can now be handled under the new rules. She noted a desire to enable national banks to compete more effectively and to adapt to changing needs in the marketplace. This represents a new recognition of the need for flexibility if national banks are to compete with other financial services providers. She also reported that a variety of new activities (specified in the new regulation) are now permissible without any prior application (this represents a major shift in regulatory policy).

All of this is part of the comprehensive revision of 23 CFR Part Five, affecting a significant decrease in the regulatory burden for national banks.

VI. State-Chartered Thrifts and Banks

James Pledger, Texas Savings and Loan Commissioner, described the challenges and opportunities facing state-chartered savings and loan associations and savings banks. Texas has had excellent success with its new (1993) state savings bank charter, which combines many of the advantages of a thrift and bank charter and is regarded by many as a model for those interested in charter modernization. He noted that in designing this charter Texas started from scratch, thereby allowing incorporation of numerous attractive features (e.g., a diversified holding company structure, flexible operating authority, the broadest possible parity provision, and an efficient low cost regulatory structure).

This charter has been popular in Texas (where many thrifts have converted to the new charter and still others are giving consideration to following suit). This charter is further enhanced by efforts of the Texas Savings and Loan Commission to maintain a reasonable and local regulatory environment that accommodates the differences between large and small institutions.

He noted that the Texas opt-out of interstate branching does not apply to Texas savings banks. This allows an out-of-state institution in a state without the savings bank option to switch to a Texas savings bank charter and retain its out-of-state operations. The authority for a unitary savings bank holding company to have diversified operations, not authorized for bank holding companies, provides exceptions opportunities for a banking institution to diversify the holding company level. This makes a state savings bank an attractive option as the financial services arm of, e.g., a diversified retailing, manufacturing, or financial enterprise. This permits a banking institution to compete with nonbank (and less-regulated) competitors.

The savings bank charter is also a very attractive alternative for smaller institutions, as a result of the local perspective and lower cost of the state regulator. The accessibility of state regulators and their reputation for flexibility are strong incentives for small institutions to favor a state charter. There seems to be a long-term trend of smaller institutions (both banks and thrifts) favoring state charters. Mr. Pledger also noted that in the minds of the public a state savings bank is a "bank" for all purposes.

Paul Foster, General Counsel for the Oklahoma Banking Department, noted that while a lot of media attention has been focused on Washington, D.C., much of the action (and innovation) continues to occur at the state level. He described the new Oklahoma Banking Code, noting that this is illustrative of widespread state efforts to modernize the

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20. Ms. Corey was retiring from Office of Comptroller of Currency, Randall Ryskamp.
23. Though not, unfortunately, actually for uninsured depositors.
VI. Court Tells Lessor: "No Need to Pay Interest on Security Deposit"

On October 18, 1996, the U.S. District Court for the Northern District of Ohio dismissed a class action against Huntington National Bank (Gaydos v. Huntington Nat'l Bank). The complaint alleged that Huntington violated state law and various disclosure requirements in the Consumer Leasing Act and Regulation M by failing to credit to lessees interest earned on required security deposits.

The Court found that Regulation M does not require disclosure of the "profits" earned by a lessor on a vehicle security deposit. In doing so, the Court expressed disagreement with two earlier District Court cases finding disclosure violations under similar circumstances—Werboskey v. Ford Motor Credit and Demitriopoulos v. Bank One Milwaukee, N.A.—The state law claims against Huntington were dismissed only for lack of federal court jurisdiction and can be refiled in state court.

VII. FTC to Lessors: "No More Mouse Print"

On November 21, 1996, the Federal Trade Commission announced settlements with five major auto manufacturers to resolve charges that certain of the manufacturers' lease advertisements disclosed substantial final balloon payments of several thousand dollars and other important credit terms in print that was so small as to be unreadable. In the settlements, the manufacturers promised essentially to fix the advertisements to ensure that they will not contain misrepresentations or fail to adequately disclose lease terms (consistent with the "equal prominence" requirement included within the New Rule). No mandatory payments are included under the settlement, although violators of the settlement could be subject to fines of $11,000 per violation.

VIII. Summary

The lesson here for automobile lessors is clear—"Stay on the road." The Board has provided the roadmap: Lessors need to follow it. If you do become lost, experienced compliance counsel can help you find your way again.

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state banking system. He also described the efforts of state regulators to accommodate the interstate banking needs of state chartered institutions.

Stephanie Bluhm of Bracwell & Patterson discussed further issues involving financial reform and state chartered institutions. She noted the provision in HOLA section 10(c) (also discussed by James Plöger) allowing a savings bank holding company to be treated as a unitary thrift holding company with a virtually unrestricted range of permitted activities. This requires the thrift or savings bank subsidiary to maintain its status as a qualified thrift lender (QTL), but Ms. Bluhm noted that QTL status is now very easy to achieve thanks to recent OTS revisions. For example, virtually unlimited consumer and credit card lending is permitted. She suggested that entities interested in unitary thrift holding company status should act now in order to be "grandfathered" in the event that financial regulatory reform cuts off this opportunity in the future. She also noted that under the FDCIA, the FDICIA prohibits state banks from equity investments not permitted for national banks, subject to limited exceptions. The implementing regulations (Part 36227) were recently issued, but exclude from the prohibition agency activities, thereby permitting expanded agency activities by state-chartered institutions as compared to the more restrictive rules for national banks. Only if the bank engages as principal is FDIC approval needed.28

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28. A list of the broader powers authorized for state-chartered banks appears in the Institute's program materials.
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VII. OFHEO

The next speaker was David J. Felt, Associate General Counsel at the Office of Federal Housing Enterprise Oversight (OFHEO), primary federal regulator of Fannie Mae (the largest U.S. private corporation) and Freddie Mac (both "government-sponsored" private enterprises, or GSEs). The value of the "subsidy" resulting from GSE status was recently estimated at $5.6 billion per year, or $4 billion of which is passed through to lenders.

Mr. Felt described the quandary faced by the "public interest" directors of Fannie and Freddie, who comprise a minority of the board and are appointed by the President, with potentially conflicting duties to serve the interests of shareholders and to act in the public interest.

OFHEO has a total of 68 employees (including examiners), a small staff considering the agency's oversight responsibilities. This necessitates a multi-level approach, by which a more detailed examination (if specific issues is undertaken only if problems are identified and cannot be resolved at a more general level. At its most detailed, however, this oversight cannot approach the scope of a typical bank or thrift examination. OFHEO examinations cover such things as derivatives, corporate governance, risk management, capital levels, business risk, and flood insurance compliance. The current requirement is for 2.5% capital (or balance sheet items and 4% for off-balance sheet items). This is based on a complex risk-based capital stress test assuming an interest rate increase of 600 basis points and a significant level of credit losses. The process of developing these tests and analyses for risks of this magnitude of complexity has never been tested or fully achieved and continues in development at OFHEO. As of the date of the program, a proposed regulation was estimated to be still a year away, and additional minimum capital requirements cannot become effective until one year after the final regulation is issued.

VIII. Regulation M

Jacqueline Atkins, counsel for BancOne Corporation in Dallas, briefly described the efforts to create a single BancOne charter in each state as a step toward interstate branching. She then described the new Regulation M on consumer leasing, including the new Commentary and the new advertising rules implementing the statutory revisions in EGPRA. A new report noted that the new Regulation M disclosures are patterned after the Truth in Lending Act and Regulation Z, in the sense of requiring that certain disclosures be segregated in a kind of "financial box." The requirements include a revised disclosure format, a total of payments disclosure, an itemization of charges used to calculate the periodic payment, a warning of possible early termination charges, and new advertising rules. These disclosures must be segregated.

No rate disclosure is required, but if a rate is disclosed it must be accompanied by a disclosure, warning in effect that the rate disclosure may not be meaningful. Rate disclosures cannot be included in the segregated portion of the form. A description of gross capitalized cost was added, to include only those items capitalized or amortized by the lessor. The consumer has a right to obtain an itemization of gross capitalized cost on request. This also cannot be within the segregated disclosures.

New model forms should help lessors comply with these new disclosure rules.

Ms. Atkins then described recent leasing litigation. Some courts have criticized lessors for not making full disclosure. But when lessors then expanded their disclosures, courts held that the disclosures constituted overload and were confusing. Again, the new rules will hopefully help address this problem. With new auto lease rates attractively low, it appears that the competitive competition in the leasing industry together with minimal substantive federal regulation and a reasonable system of disclosure rules is creating an optimal market for consumer leases.

IX. RESPA

Robert Wiener of O'Connor, Winter & Craig described the rapid pace of recent RESPA developments, including scope issues, servicing disclosures, good faith estimates and the settlement statement, referral fees, CLOs and Affiliated Business Arrangements, broker fees, and escrow accounts.

Mr. Wiener noted four differences in the scope of Truth in Lending and RESPA, and the effort required under EGPRA to reconcile the business purpose exceptions. He noted that HUD and the FRB concluded the statutory revision is needed before the agencies can meet the EGPRA mandate to reconcile the TILA and RESPA requirements. Referral fees represent a major RESPA battle ground.

Mr. Wiener noted that any referral fees being paid must be within the exceptions to the general prohibition or the fees will violate RESPA. A HUD Policy Statement of September 19, 1996 deals with these issues. Employee payments, CLOs and Affiliated Business Arrangements (ABAs) are a part of these issues. HUD has issued a Statement of Policy 1996-3, governing office rental arrangements that include a referral fee component (An office rental that exceeds fair market value is based on loan referrals may be considered a prohibited referral fee.

Mr. Wiener noted HUD's conclusion that lender "lock outs" and employee retaliation are issues better handled under other law.


34. 61 Fed. Reg. at 52249.

35. Consumer advocates sought a uniform rate disclosure but the FRB concluded that the necessary calculations were too early to be credible.


37. Ms. Atkins' institute program materials include a bibliography of recent cases.


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QUARTERLY REPORT

The OCC has defined the risk components subject to examination, credit risks, market risks, operational risks, liquidity risk, foreign exchange risk, concentration risk, compliance risks, strategic risks, and reputational risks. The OCC notes, however, that for small and medium-sized banks the examination will continue to concentrate on credit risks. Ms. Pringle emphasized that safety and soundness procedures differ from the consumer credit community and should not focus on technical issues, and that the executive's concept of safety and soundness is that the various issues and practices should be more judgmental and discretionary as in the "black letter law" approach compared to an industry's discretion in the dealing with issues.

The eligibility requirements included in Subchapter S of the Internal Revenue Code are the same for all tax returns. Among other things, there can be no more than 50 shareholders. Financial institutions using the reserve method of accounting may net unrealized gains and losses in their financial statements.

Mr. Pringle described the current regulatory reforms to investors and management of institutions, including insider transactions and allocation transaction risks under IRC 355. These include special lending limits for troubled debt under IRC 385 and a requirement for procedures to review insider transactions.